No. 89-530

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In The

Supreme Court of the United States

October Term, 1989

PORTLAND GOLF CLUB,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED

Whether the lower court erred in holding that Petitioner, a tax exempt social club, may properly deduct losses from a nonmember activity only if it undertakes that activity with the intent to profit, where profit means the production of gains in excess of all variable and properly allocated fixed costs.

PARTIES BELOW

Parties before the United States Court of Appeals for the Ninth Circuit were Portland Golf Club as Appellee and the Commissioner of Internal Revenue as Appellant.

Portland Golf Club has no parent company or subsidiaries.

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Court of Appeals (J.A. 44-45)[1] is not reported. The opinion of the United States Tax Court (J.A. 25-42) is not officially reported, but is unofficially reported at P-H Memo T.C., par. 88076.

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[1] "J.A. ___" references are to the Joint Appendix filed by the parties.

JURISDICTION

The judgment of the Court of Appeals (J.A. 46.) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time for filing a writ of certiorari to and including September 29, 1989. The Petition was filed on September 28, 1989, and was granted on January 16, 1990. (J.A. 47.) The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 511 and 512 of the Internal Revenue Code of 1954 (26 U.S.C.) are set out in a statutory appendix, App. A, *infra*.

STATEMENT

1. Petitioner is a nonprofit Oregon corporation exempt from tax pursuant to Section 501(c)(7) of the Code.[2] (J.A. 15, 26.) Since 1914, Petitioner has owned and operated a private club, including a golf course, restaurant, bar, swimming pool and tennis courts, for the benefit of its members, their guests and nonmembers. (J.A. 16, 26.)

During the fiscal years 1980 and 1981 in issue, Petitioner derived the vast majority of its income from membership dues and other fees paid by members for goods and services provided to the members and their guests. (J.A. 36.) Members were allowed to sponsor guests, friends, and organizations to use Petitioner's facilities

[2] "Code" references are to the Internal Revenue Code of 1954.

and services for private parties, receptions or catering, and such activities generally generated unrelated business income. (J.A. 19, 27.) In addition, Petitioner followed prudent business standards by retaining funds for improvements and contingencies in the form of short-term investments. (J.A. 17, 27, 31-32.) The income earned on these investments was also unrelated business income. (J.A. 17.) The total income earned from sales of food and beverages to nonmembers, as well as from investments, constituted Petitioner's total gross unrelated business taxable income. (J.A. 17, 36.)

In providing food and beverages to nonmembers, Petitioner incurred two types of expenses: (i) variable expenses (those which vary depending on the amount of food and services provided), such as food and beverage costs, payroll, and other costs; and (ii) fixed overhead (facilities and personnel) which was used for both exempt function and nonmember purposes. (J.A. 17, 27, 29.) In preparing its tax returns, Petitioner consistently deducted all of the variable expenses related solely to providing goods and services to nonmembers; it also deducted an allocable portion of the fixed overhead expenses attributable to the facilities and personnel used for both exempt function purposes and non-exempt function purposes, in accordance with Proposed Treasury Regulation Section 1.512(a)-3(b)(5).[3] (J.A. 17, 27.) These fixed overhead expenses consisted of those which were approximately the same amount regardless of the amount of food

[3] This proposed regulation was issued on May 13, 1971 (36 Fed. Reg. 8809), and was withdrawn on January 29, 1987 (52 Fed. Reg. 2724).

and related services provided to nonmembers, such as taxes, depreciation, utilities and salaries. (J.A. 17, 27.)

Petitioner's prices for sales of food and beverages to nonmembers were in excess of the prices of food and beverages served to members (J.A. 28.) It priced the sale of food and beverages to nonmembers so that the cost of food was about 30 to 33 percent of the selling price of the meal (J.A. 28.) The prices of food and beverages at nonmember activities was set by the Board of Directors and the club management at an amount intended to result in a profit to the club over the variable (direct) costs associated with the activity (J.A. 31.) In addition, these activities were promoted with the intent to attract additional members to the club and thereby to generate additional income from initiation fees, and to sharpen the skills of the chef and his staff (J.A. 31.)

Petitioner's activities were run in a businesslike manner, and it kept complete and accurate books and records of its activities. (J.A. 30.) Its Board of Directors and Finance Committee closely supervised the food and beverages operations, and in 1981 conducted a study showing that the income from sales of food and beverages to nonmembers substantially exceeded all variable costs plus a portion of the dual use fixed overhead costs, allocated based upon the number of nonmembers served divided by the total number of people served. (J.A. 30-31, 78-79, 81-84.) One of the conclusions in this report was that since nonmembers spent more per meal than members, the club should increase the number of nonmember meals served each month and encourage club members to bring in nonmembers for lunches, dinners, and special functions (J.A. 30-31, 78.)

Petitioner's day-to-day operations were supervised by a full-time manager with substantial club management experience. (J.A. 30, 31.) He held degrees in hotel and restaurant administration and recreation administration; he had previously been employed by hotels and other private clubs; and he was an officer of various club and restaurant associations. (J.A. 30, 31.)

Petitioner was concerned about the profitability of private party income, substantially all of which was nonmember business. (J.A. 31; RT 27-35.)[4] It conducted numerous reviews and studies of the profitability of private party income. (J.A. 30-31, 73-85; J. Exs. 7-G, 8-H, 9-I, 10-J, 11-K, 16-P, 17-Q.)[5] Had Petitioner chosen to report fixed overhead expenses for nonmember activities using an allocation method employing square foot and hours of actual use of facilities for the nonmember activities,[6] it would have had net taxable income for income tax purposes from the sale of food and beverages to nonmembers of $19,448 in fiscal 1980 and $23,474 in fiscal 1981. (J.A. 29.)[7]

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[4] "RT ___" references are to the trauscript of the Tax Court trial, which was not reproduced in the Joint Appendix.

[5] "J. Ex ___" reference are to the joint exhibits which were part of the stipulation of facts in the Tax Court, and which are not reproduced in the Joint Appendix.

[6] This "actual use" allocation method has been adopted by the Government as an example of a reasonable allocation method in the 1980 and 1982 editions of Exempt Organizations Continuing Professional Technical Instruction Programs issued by the Exempt Organizations division of the I.R.S. National Office. This method was also found to be reasonable by the court of appeals in *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984).

[7] A schedule showing how net income was computed using such an allocation method is reproduced at Appendix B, *infra*.

Since 1975, through and including the years at issue, Petitioner, in its tax returns, has used another allocation formula in order to compute the amount of fixed overhead allocated to and deducted from its unrelated business taxable income. This allocation method was based on the ratio that nonmember sales bore to total sales, and was stipulated by the parties to be reasonable. (J.A. 17, 27, 28.) The parties further stipulated that for the years at issue, an allocable portion of Petitioner's fixed overhead costs was properly attributable and directly connected to the generation of nonmember income. (J.A. 18, 28.)

Using this "gross-to-gross" allocation formula, Petitioner's unrelated business tax return reported losses on nonmember food and beverage sales for fiscal 1980 and 1981. Petitioner offset these losses against its taxable investment income, and reported a net loss in each year. (J.A. 32.) The Commissioner refused to allow the loss deductions, and asserted tax deficiencies of $1,828 for fiscal 1980 and $3,470 for fiscal 1981. (J.A. 32, 50-51.)

2. In the Tax Court, the Government conceded that Petitioner properly allocated its nonmember deductions to nonmember gross income, and that such deductions satisfied all requirements of Title 1 of the Code save one. But the Government maintained that a club must satisfy the "trade or business" requirement of Section 162 and correlative statutes by establishing it had a profit motive, by reporting an excess of gross income over deductions on its unrelated business tax return. Since Petitioner did not earn a tax profit computed under this formula, the Government refused to allow it to deduct the reported tax loss on its nonmember food/beverage activity to offset its investment income.

Petitioner primarily argued that Section 512(a)(3), which defines unrelated business income and deductions for exempt social clubs, does not, as a matter of law, require a profit motive to exist as a prerequisite to deductions. Alternatively, Petitioner argued that, on the facts presented, it had the appropriate profit motive as defined by settled case law.

The Tax Court did not pass on Petitioner's legal argument, but instead applied the normal profit motive tests which it usually applies in tax shelter, sale-lease-back, hobby, and other cases involving trade-or-business deductions. It reviewed all the facts and circumstances, including the profit statistics described above, and held that Petitioner had a profit motive for its sales to nonmembers and was entitled to deduct all its directly connected expenses. It relied in part on the fact that Petitioner earned a profit when it computed its nonmember food/beverage income using other permissible allocation methods, although it had continuous losses under the permissible allocation method used on the tax return. (J.A. 25-42.) In so holding, the Tax Court relied on its prior unanimous reviewed opinion in *North Ridge Country Club v. Commissioner*, 89 T.C. 563 (1987). (J.A. 37-42.)

3. The Court of Appeals reversed (J.A. 44-45), in a rationale fully explicated in *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989), which had similar facts and was argued and decided with the instant case. The court rejected the reasoning of the Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (6th Cir. 1985), which held that Section 512(a)(3)(A) did not incorporate the "trade or business" and profit motive requirements of Section 512(a)(1). The Ninth Circuit held that Section 512(a)(3)(A) implicitly contains a "trade or

business" and profit motive requirement for a deduction, and disregarded the Sixth Circuit's position that Congress deliberately included these requirements in Section 512(a)(1) which governs deductions of other exempt organizations, but excluded those terms from Section 512(a)(3) which authorizes the corollary deductions for exempt social clubs. In the instant case, the Ninth Circuit opinion (J.A. 44-45) incorporated by reference its interpretation of Section 512(a)(3)(A) in the *North Ridge* opinion.

The Ninth Circuit rejected, however, the Government's proposed "profit" definition – that profit means taxable income as reported on a taxpayer's income tax return. Instead, the court adopted its own definition of profit motive – that it requires "an intent of producing gains in excess of direct costs (costs related to the nonmember activity) and indirect costs (overhead and other fixed expenses)", with costs computed under any reasonable method of allocation. The court therefore remanded the case to the Tax Court, to allow Petitioner to prove that it intended to earn a profit using the "actual use" allocation method, as contrasted with the "gross to gross" allocation method used on the return. (J.A. 44-45.)

SUMMARY OF ARGUMENT

1. (a) This case involves the correct method for determining the unrelated business taxable income of membership social clubs. These clubs are tax-exempt in name only, and pay tax as provided in Section 511(a) of the Internal Revenue Code on their net unrelated business income as determined under the definition set forth in Code Section 512(a)(3)(A). The issue in this case is whether a social club, exempt under Section 501(c)(7),

may deduct expenses in excess of its gross income on one taxable unrelated business activity (here nonmember food and beverage business), and use the loss to offset net income from another taxable unrelated business activity (here net investment income).

When social clubs were first made subject to the unrelated business tax in 1969, Congress provided two different computational formulas. Section 512(a)(1) is applicable to most exempt organizations, and Section 512(a)(3)(A) is applicable only to social clubs and voluntary employees' beneficiary associations. Section 512(a)(1) provides that an activity must satisfy the "trade or business" test of Section 513, and other requirements, in order to be an unrelated business subject to tax. All other income is exempt, and expenses directly connected to such income are nondeductible. Section 513 specifically requires that an unrelated business must satisfy the profit motive requirement of Section 162. In general, Sections 512(a)(1) and 513 define unrelated business income and deductions narrowly, to reflect Congress' desire to exempt broadly the activities of public benefit organizations to which the statutes apply.

Section 512(a)(3)(A) is structured completely differently. The statute defines "unrelated business income" as *all* gross income, except a narrowly defined class of "exempt function income." In general, only dues, fees and other similar payments by members constitute exempt function income. The definition of allowable deductions exactly tracks the corresponding gross income: all expenses directly connected to gross income are deductible, except those expenses directly connected to exempt function income. Congress' purpose was to define narrowly

the exempt income and the exempt function expenses, in view of the more limited exempt purposes of social clubs.

The parties agree that all of the expenses in issue were "directly connected" with Petitioner's unrelated business "gross income" within the meaning of the Section 512(a)(3)(A), and that they are the types of corporate expenses allowed as deductions by Code Section 162 and correlative expense deduction statutes. But the Government contends that some activities generating expenses do not satisfy the "profit motivation" test under Section 162, and therefore are not deductible. Petitioner contends that Section 512(a)(3)(A) defines the activity producing the expenses here as an unrelated "business", and that there is no need to apply the profit motive test to redetermine if the activity is a "business".

The critical flaw in the Government's position is its assumption that Section 162 cannot support a deduction unless the taxpayer's activity meets a separate test that it was profit motivated. Code Section 162 does not itself contain a term requiring a "profit motive"; profit motive only is relevant to determine if an activity satisfies the term "trade or business" in Section 162. While a profit motive is generally necessary for an activity to rise to the level of a trade or business, that is not always necessary.

Congress in Section 512(a)(3)(A) deliberately fashioned a special definition for the unrelated "business" activities of an exempt social club which encompassed a broad group of activities, many of which do not constitute a "trade or business" as that term is used in Section 162. Congress created this special definition for unrelated business activities of an exempt social club in

order to subject these activities to tax. Through this special definition, Congress declared that the income from these activities was unrelated *business* income; and that the expenses directly connected to these activities were unrelated *business* expenses. Once Congress defined that activity as unrelated *business* activity, the expenses directly connected to these activities become expenses incurred in carrying on a trade or *business*. There is no need to apply the profit motive test to determine if the activity is a trade or business.

The legislative history of Section 512(a)(3) flatly rejects the Government's present trade or business theory. The Treasury Department in proposing the statute stated that all "deductions would be allowable if directly connected with an activity generating income subject to tax, *rather than only if directly connected with an unrelated trade or business* * * * ." The Committee Reports state that "all income", other than member income, "would be *treated* and taxed as business income."

The Government's position also contradicts the plain terms of Section 512(a)(3)(A). The statute requires a computation of all of the "deductions allowed by this chapter which are directly connected with the production of the gross income." This computation assumes that some expenses are both "allowed by this chapter" and "directly connected with" exempt functions. A profit motive test contradicts this assumption, because exempt functions are seldom profit motivated.

(b) The Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (1985), endorsed Petitioner's rationale set forth above, emphasizing that Section 512(a)(3) provided its own sui generis computational formula, which expressly excluded the "profit motive" requirement. However, the case did not give clubs carte blanche in deducting expenses. It recognized Congress' intent to preclude deduction of expenses related to all exempt (member) function activities against income from unrelated business activities. The Court did this by recognizing that even nonprofit organizations may not deduct personal or hobby expenditures. Accordingly, it ruled that directly connected nonmember expenses would only be deductible if incurred in connection with an activity producing "economic gain"; hobby and other personal expenses of members would not be deductible even if camouflaged as from nonmember activities.

This requirement is not a new test to see if an expense directly connected to an unrelated business activity is deductible, but rather goes to the heart of whether the activity is an unrelated business activity or an exempt activity. If an activity is priced so that the gross income does not exceed the variable expenses (expenses which would not be incurred but for the activity), the activity is not being conducted for an economic gain and is at least partially paid for by the members out of their dues. In that event, the members must be benefiting from this policy in some way, and the activity is really an exempt activity, not an unrelated business activity. If it is an exempt activity, the expenses are not deductible against unrelated business income.

Here, it is undisputed that Petitioner always charged prices to nonmembers which far exceeded its variable

costs, so the Sixth Circuit's formula, including its guard against member expenses being deductible against unrelated business income, would require reversal of the Ninth Circuit's decision below.

(c) The Government's proposed incorporation into Section 512(a)(3) of the "profit motive" requirement to determine if there is a Section 162 trade or business conflicts with decisions of this Court holding that there are no uniform definitions of the terms "trade" or "business" applicable throughout the Internal Revenue Code, and that the terms must be adapted to meet the purposes of the particular statute. The Government's position also conflicts with decisions holding that when Congress has artificially treated activities as trades or businesses by statutory decree, as Congress has done in Section 512(a)(3)(A) here, they are not reexamined to determine if there is a profit motive to establish a business expense.

2. The Tax Court did not address the arguments above regarding whether a profit motive test was incorporated into Section 512(a)(3)(A). It held for Petitioner on the alternative basis that it had a profit motive and was carrying on a trade or business under all the facts and circumstances. The court correctly applied the traditional profit motive standard which it has long used in dozens of "trade or business" cases. In accord with the consistent rulings of this Court, such as *Commissioner v. Groetzinger*, 107 S.Ct. 980 (1987), the Tax Court analyzed all of the facts, such as use of standard business techniques, employment of trained and experienced managers, devotion of time and resources of directors and management to planning and operations, charging of competitive prices,

and intent and efforts to earn an economic profit, and properly found that Petitioner had a profit motive.

The Government agreed with most of the factors applied by the Tax Court, and that Petitioner satisfied the profit motive test which the Tax Court applied. However, the Government insists that the Tax Court's test is legally wrong, on the basis that "economic profit" is the wrong definition of profit. Under the Tax Court's many decisions, "economic profit" will vary somewhat according to the facts and circumstances, but often means cash flow – *viz.*, an excess of gross receipts over variable costs. By contrast, the Government argued that profit always means "tax profit" – an intent to earn gross income in excess of lawfully deductible expenses as determined under the Internal Revenue Code.

The Government's rigid computational approach would wreak havoc with the administration of the most important expenses deduction provisions in the Code – Sections 162 (trade or business expenses), 165 (trade or business losses), and 167 (trade or business depreciation). Taxation of corporations and other businesses would be revolutionized, since many such entities have continuing *tax* losses, but earn substantial economic profits. Many large corporations have claimed tax losses for several consecutive years, while reporting billions of dollars in profits to their shareholders and the SEC for the exact same period. In response to this perceived abuse, Congress in 1986 acknowledged that the normal income tax rules did not always tax real economic profits, and imposed the alternative minimum tax on such economic profits. Such legislation would not have been necessary if the I.R.S. could simply disallow tax deductions which

continually exceeded gross income as being incurred without an intent to make a profit.

Moreover, the voluminous caselaw and legislation on tax shelters, including the complex passive loss rules enacted in 1986, would become moot because many tax shelters by definition have continuous *tax* losses; now they are only required to demonstrate an intent to earn an "economic profit" in order to obtain deductions under Sections 162, 165, and 167.

The Government's theory that "profit" for profit motive purposes equals taxable income is contrary to the overwhelming weight of the cases, Treasury Regulations, legislative history, accounting literature, and law review authors. It even conflicts with the only published ruling under Section 512(a)(3), which states that profit equals gross income less "costs of sales."[8]

Congress intended to tax the taxable side of a social club like a regular taxable corporation conducting a business. Section 162 does not prevent a taxable business from offsetting losses on one taxable activity (e.g., a department store restaurant) against profits on another taxable activity (e.g., the department store's jewelry department). The Government's position on club losses is discriminatory and unfair; "heads I win, tails you lose."

For these reasons, we submit that the Tax Court's decision should be affirmed, and that the Ninth Circuit's opinion should be reversed.

3. The Ninth Circuit below developed its own unique meaning of profit motive, defining profit as "the production of gains in an excess of all direct and indirect

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[8] Revenue Ruling 81-69, 1981-1 C.B. 351.

costs." *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989). In this case below, the Ninth Circuit reversed the Tax Court's decision because, in the Appeal Court's view, the trial court had erred by using the wrong standard of "profit", but remanded the case to the Tax Court for a determination whether Portland Golf Club had a profit motive as required under *North Ridge*, "[b]ecause Portland Golf Club could have reported gains in excess of direct and indirect costs, but did not do so, relying on a method of allocation stipulated to be reasonable by the Commissioner." We believe Petitioner here also satisfies the *North Ridge* standard, but we believe the Tax Court's test is preferable.

ARGUMENT

I

CODE SECTION 512(a)(3) DOES NOT REQUIRE EACH UNRELATED BUSINESS ACTIVITY OF A SOCIAL CLUB TO EARN TAXABLE INCOME IN ORDER TO DEDUCT ALL EXPENSES DIRECTLY CONNECTED WITH SUCH ACTIVITY

A. The Language and Legislative History of Section 512(a)(3) Eliminate the Trade-or-Business and Profit-Motive Requirements

Petitioner is a social club which is nominally tax exempt under Section 501(c)(7) of the Internal Revenue Code, Appendix A, *infra*. The taxation of Section 501(c)(7) clubs is governed by Code Section 512(a)(3), Appendix A, *infra*. To fully understand the issues of this case, one must have an understanding of the language and legislative history of the statutes relating to tax exempt status of certain organizations, and the exceptions pursuant to

which the net income of some of such exempt organizations' activities may be subject to tax.

The Congressional purpose in adopting Code Sections 401 and 501, providing for exemption from taxation of certain organizations, was twofold[9]:

1. To promote certain publicly beneficial activities by removing from them the burden of taxation; and
2. To allow persons to conduct certain mutually beneficial activities as a group rather than individually, without the added burden of a group level tax.

Prior to 1969, the unrelated business tax did not apply to exempt social clubs and voluntary employees beneficiary associations. When Congress extended the tax to these organizations in 1969, it established separate unrelated business tax computation provisions: Section 512(a)(1) was designed to apply to what were deemed to be organizations whose exemptions were based on publicly beneficial purposes; Section 512(a)(3) was designed for organizations whose exemptions were based on mutual benefit.

Section 512(a)(1), Appendix A, *infra*, sets forth a *general* definition of "unrelated business taxable income" which is not applicable to social clubs.[10] This *general*

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[9] See J. Desiderio and S. Taylor, *Planning Tax-Exempt Organizations*, § 4.03 (1986).

[10] Section 512(a)(1) provides as follows:

> *Except as otherwise provided in this subsection*, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated *trade or business* (as defined in Section 513) regularly carried on by it, less the deductions

(Continued on following page)

definition explicitly requires an activity to be an "unrelated trade or business (as defined in section 513) regularly carried on by it", in order for income and deductions directly connected to such activity to be includable in the unrelated business category and subject to tax.

The entire thrust of Sections 512(a)(1) and 513 is to define narrowly the activities which constitute taxable "unrelated business" activities; everything remaining constitutes exempt activities not subject to the tax. This corresponds to Congress' general purpose for the unrelated business income tax: to eliminate the unfair advantage of tax exemption only when the exempt organization directly competes with a taxable organization in an activity which is not substantially related to its exempt purposes. All other activity is intended to be exempt from tax because it is used to help promote the publicly beneficial purpose of the exemption. Once an activity is determined not to be an unrelated business activity, it is not reexamined to see if it directly promotes the exempt purpose. If such an examination were to be conducted, many activities would shift between being an exempt activity, if tested by the unrelated business standard, and an unrelated business activity, when tested by the exempt standard. This shifting occurs because a particular activity may not clearly meet either standard.

Code Section 513 defines a "trade or business" for purposes of Section 512(a)(1); it does so by incorporating

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allowed by this chapter which are directly connected with the carrying on of such *trade or business*, both computed with the modifications provided in subsection (b). (Emphasis added).

the requirements of a trade or business as outlined by the cases dealing with that question under Section 162, including the requirement of a profit motive. The definition is then further refined by specific statutory provisions which either include an activity or exclude an activity from the trade or business category.

If an activity conducted by an exempt organization governed by Section 512(a)(1) lacks a profit motive or any other requirement of a trade or business under Section 513, it does not meet the Section 512(a)(1) requirement that it be a trade or business, and it can not be an unrelated business activity. If it is not an unrelated business activity under Section 512(a)(1), it is by definition an exempt activity not subject to tax. If an activity is an exempt activity, the expenses from such activity may not be used to offset net income from unrelated business activities. *Iowa State University of Science and Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974); *Ye Mystic Krewe of Gasparilla v. Commissioner*, 80 T.C. 757 (1983).

Congress in Section 512(a)(3)(A)[11] adopted an entirely different approach. This statute is a special provision applicable (during the years at issue) only to social clubs

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[11] Section 512(a)(3)(A) provides as follows:

In the case of an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the term "unrelated business taxable income" means the *gross income* (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the *gross income* (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). (Emphasis added).

exempt under Code Section 501(c)(7), and voluntary employees' beneficiary associations exempt under Section 501(c)(9). Unlike the general rule of Section 512(a)(1), Section 512(a)(3)(A) defines "unrelated business taxable income" broadly – it is *all* gross income, except exempt function income. The statute defines narrowly the category of exempt activity, thereby furthering the Congressional intent to allow a tax exemption to social clubs only for activities directly connected to their exempt function. All other activities are subject to tax in the same manner as any taxable business is taxed. Just as some activities in the exempt category in Section 512(a)(1) would not meet an external test of exempt activities, so not all the activities which are categorized in Section 512(a)(3)(A) as unrelated business activities meet an external test of a trade or business. Congress did not intend that these activities should meet some external "business" test.

The plain and ordinary meaning of the language of Section 512(a)(3)(A) is reinforced by its legislative history. Section 512(a)(3) resulted from a proposal by the Treasury Department. In explanation of its proposal, the Treasury Department stated that the "trade or business" concept has no place in Section 512(a)(3):[12]

> Thus, under the proposal, *all income*, other than that from members in exchange for exempt function facilities, would be included in gross income, *whether or not the activities generating*

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[12] *Technical Explanation of Treasury Tax Reform Proposals, Hearings on the Subject of Tax Reform Before the Comm. on Ways and Means*, 91st Cong., 1st Sess., Part 14, at 5059, 5139-5140 (April 22, 1969) (emphasis added). Accord, Department of the Treasury, *Tax Reform Studies and Proposals* (House Ways & Means Comm. & Senate Finance Comm. Jt. Pub. Feb. 5, 1969), Pt. 3, at 324.

> *the income were sufficient to meet the requirements of a "trade or business* regularly carried on" generally applicable under the unrelated business income tax.

The Treasury Department's explanation reiterated this position at a later point:[13]

> [C]onsistent with the elimination of the "trade or business regularly carried on" tests, deductions would be allowable if directly connected with *an activity generating income* subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on.

The House Ways and Means Committee report stated that under Section 512(a)(3), "all income other than that derived from rendering services to the members * * * *would be treated and taxed as business income.*" H.R. Rep. No. 413, 91st Cong., 1st Sess. (Pt. 1) 47 (1969-3 C.B. 200, 231) (emphasis added).

B. Since Section 512(a)(3)(A) Deems Unrelated Activities To Be "Business" in Character, the Profit Motive Prerequisite for a Section 162 "Business" Is Irrelevant

Section 512(a)(3)(A) of the Code defines "unrelated business taxable income" of a social club as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income (excluding exempt function income)." This statute establishes a two prong test for the deduction of expenses in determining unrelated business taxable income: (1) the expenses must be of a kind which is allowed as a deduction to a

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[13] Technical Explanation, *supra* note 11 at 5141 (emphasis in original); *Tax Reform Studies and Proposals, supra* note 11, at 325.

business under Chapter 1 of the Internal Revenue Code; and (2) the expense must be directly connected with the production of income by an unrelated business activity. There is no question that all the expenses taken by Petitioner as deductions in determining its unrelated business taxable income were directly connected to the production of such income. The Government has stipulated to this fact. (J.A. 18.)

The issue in dispute is the interpretation of the phrase "less the deductions allowed by this chapter." Petitioner is a corporation, and so only deductions available to a corporation are "allowed by this chapter." The activities conducted by Petitioner which give rise to the expenses are by definition unrelated *business* activities, so deductions allowed in the conduct of a business are allowed by this chapter. Expenses which are allowed as deductions only to individuals or which are never allowable are not "deductions allowed by this chapter," but no expenses of that kind are in issue here.

For a deduction to be allowed by this chapter as required by Section 512(a)(3)(A), the Government would take the position that activities of a social club which are categorized as unrelated business activities must be subjected to a reexamination to determine if they are carried on for a profit and therefore constitute a trade or business as defined by caselaw interpreting Section 162. The critical flaw in the Government's analysis comes from a misinterpretation of how the profit motive test is used in conjunction with Section 162. Code Section 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The profit motive test is not a separate Section 162 statutory term; rather, it is used to determine

whether the activity which produced the expense satisfies the "trade or business" term. If the activity is a trade or business, the expense may be deductible, if it also meets the other statutory terms of Section 162. If the activity is not a trade or business, then the expense is not even tested under the remainder of Section 162.

Generally a profit motive is a necessary factor in determining whether an activity is a trade or business. This is so because most activities could be a "trade or business", or they could be a hobby or other personal activity, depending on all the facts and circumstances surrounding the pursuit of the activity. However, there are some activities which Congress has singled out and defined as business activities. See *Commissioner v. Groetzinger*, 107 S.Ct. 980, 983 fn. 6 (1987). The unrelated trade or business of an exempt organization taxed under Section 512(a)(3) is one example. Government service is another example of an activity that Congress has defined as a business activity. Code Section 7701(26). See *Frank v. United States*, 577 F.2d 93 (9th Cir. 1978). Where Congress has defined an activity as a "business," there is no need to test the activity further for profit motivation.

C. The Plain Meaning of Section 512(a)(3)(A) Provides a Computational Formula for Unrelated Business Taxable Income which Precludes the Application of a Profit Motive Test

A closer analysis and comparison of the language and computational structure of Sections 512(a)(1) and 512(a)(3)(A), respectively, demonstrates that Section

512(a)(1) requires income and deductions to satisfy Section 162 trade or business and profit motive requirements, while Section 512(a)(3)(A) eliminates such requirements.

Section 512(a)(1) provides that unrelated business income includes only the gross income derived from "any unrelated trade or business (as defined in Section 513)." By contrast, Section 512(a)(3)(A) defines unrelated business income as the club's entire "gross income". The only exclusion is "exempt function income", which is defined in Section 512(a)(3)(B) to mean the "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities or services in furtherance of the purposes constituting the basis for exemption of the organization to which such income is paid." This concept of unrelated business income means that only the dues, fees and receipts for goods, facilities or services received from a club's members are excluded from gross income for purposes of computing the club's unrelated business taxable income.[13] It follows that all other gross income – including all investment income, and all receipts for goods, facilities or services paid by non-members – are included in gross income for purposes of computing Petitioner's unrelated business taxable income. The concept of a profit motivated "trade or business" is totally at odds with this Section 512(a)(3) definition of unrelated business gross income.

The difference in scope between Section 512(a)(1) and Section 512(a)(3)(A) is further reflected in their respective

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[13] See Proposed Regulation § 1.512(a)-3, which provides that all items of gross income are added together, and then member income is excluded.

provisions governing deductions. As explained above, Section 512(a)(1) requires a Section 513-defined trade or business. By contrast, to determine deductible expenses, Section 512(a)(3)(A) starts with all of the club's expenses (both exempt and unrelated) which are "allowed by this chapter"[14] to be deductible. The statute includes expenses which are "directly connected" with exempt (member) revenues and those "directly connected" with unrelated (nonmember) revenues. From the total of such "directly connected" expenses, Section 512(a)(3)(A) requires the club to exclude the expenses directly connected with "exempt function income"; the remainder is the amount of tax-deductible expenses.[15]

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[14] The reference here is to Chapter 1 of the Code, which covers Sections 1 through 1399.

[15] The language of Section 512(a)(3) is fundamentally a description of an arithmetic formula, designed to separate exempt and unrelated business revenues and expenses. The formula may be represented mathematically by three successive computations as follows:

(i)		Total gross income
	minus:	exempt function income
	equals:	Unrelated gross income
(ii)		"Deductions allowed by this chapter * * * directly connected with gross income"
	minus:	"Deductions allowed by this chapter * * * directly connected with * * * exempt function income"
	equals:	Total deductions allowed
(iii)		Unrelated gross income
	minus:	Total deductions allowed
	equals:	Unrelated business taxable income

It is apparent that the plain statutory terms of Section 512(a)(3) leave no room for any trade or business requirement for deductions. The Government's position is that the phrase "allowed by this chapter" requires a profit motive test to be applied. However, there is no point in the Section 512(a)(3)(A) calculation when the unrelated activity and its directly connected expenses are segregated from exempt function expenses so that the profit motive test could be applied. The statutory mathematical formula becomes impracticable if the trade-or-business and profit-motive requirements are imposed.[16]

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[16] See Proposed Treasury Regulation § 1.512(a)-3(a)(2), which provides that all the club's directly connected deductions are to be added together, and then the deductions directly connected with exempt functions are to be excluded. Since all directly connected expenses constitute the starting point for deductions, Congress could not have intended to apply a trade-or-business or for-profit requirement, because member functions would typically not be a trade or business and would not be profit motivated.

In the instant case, deductions for fixed expenses were computed using *all* Petitioner's directly connected expenses as a starting point, and from this amount then deriving the fixed nonmember expenses through an allocation formula:

$$\text{fixed expenses directly connected to all gross income} \times \frac{\text{nonmember gross income}}{\text{gross income}} = \text{fixed expenses directly connected to nonmember income}$$

This allocation was stipulated to be correct by the Government. (J.A. 17.) The formula would be impossible to implement if "fixed expenses directly connected to all gross income" had to satisfy a trade or business or profit motivation requirement.

D. The Sixth Circuit's "Economic Gain" Test Correctly Follows the Language of Section 512(a)(3)

The Sixth Circuit in *Cleveland Athletic Club v. United States*, 779 F.2d 1160 (1985), agreed with the statutory analysis set forth above, to the effect that the Section 162 profit motive requirement was not included by the terms of Section 512(a)(3)(A). It emphasized that the Section 512(a)(3)(A) terms included all income (not just trade or business income) in "gross income" subject to tax, and reasoned that it would be unfair to limit deductions to expenses directly connected to gross income which constituted a trade or business as that term is narrowly defined for purposes of Section 162. The Court also recognized, however, that Congress had enacted Section 512(a)(3)(A) to prevent members from taking deductions for their own recreational expenses against taxable unrelated business income, and concluded that a club's unrelated business activity must have a purpose of "economic gain," and not be primarily member hobby or recreational activities camouflaged by nonmember formalities.

Code Section 512(a)(3)(B) defines exempt function income as payments made by members for goods, facilities or services provided to the members, their dependents or guests in connection with social or recreational activities. If this statute were to be read too literally, an exempt activity could be cateogrized as an unrelated business activity, if nonmembers paid any portion of the cost of the activity. For example, a club's members could hold a banquet for their nonmember friends, charge the nonmembers a nominal fee, and then attempt to deduct the directly connected expenses from other unrelated taxable gross income.

We believe that the economic gain test accords with the words of the statute, while furthering the Congressional intent. One Congressional purpose in enacting Section 512(a)(3) was to prevent members from using their personal, hobby or recreational expenses to offset income from unrelated business sources. S. Rep. No. 91-552, 91st Cong., 1st. Sess. 71 (1969). The statutory formula accomplishes this automatically in almost all cases, by strictly segregating exempt function and unrelated business income and expenses.

However, it is possible that, despite the statutory computational formula, some exempt function expenses could be placed in the unrelated business category. For example, a hunting club might hold an outing for nonmember friends of the members, and deliberately charge such nonmembers fees that were lower than variable (direct) costs. Too literal a reading of the statute could result in this type of activity being classified as unrelated business activity, and result in the deductibility of the directly connected net losses against other unrelated business net income. The application of the economic gain test shows that this type of activity is actually an exempt function activity.

At first blush the "economic gain" requirement appears to act in the same manner as the profit motive test proposed by the Government; however, that is not the case. The "economic gain" requirement is not a test of whether an expense directly connected to the production of unrelated business income is deductible, but is used to determine who actually pays for the cost of the activity, the members or the nonmembers. An activity results in

"economic gain" where the income from the activity exceeds the additional direct (variable) costs of conducting the activity, even though the income might not exceed the total of all variable and fixed costs combined. In that event, the members pay no additional amounts because of the activity. If the activity does not result in an "economic gain", however, the members pay some or all of the actual cost of the activity. If the members conduct or allow to be conducted activities which do not result in an "economic gain" for the benefit of nonmembers, there is a high degree of likelihood that the nonmembers are really guests of the members and that the activity is an exempt activity.[17]

Since the Cleveland Athletic Club always charged fees to nonmembers which exceeded variable costs, but had tax losses merely resulting from deductions of allocated fixed costs (e.g., depreciation, taxes, interest), the Sixth Circuit properly held that the "economic gain" test was satisfied. Similarly here, Petitioner always charged prices to nonmembers in excess of its variable costs; all of its deducted expenses satisfy the "economic gain" test.

E. Allowing Social Clubs to Aggregate Income and Losses on their Taxable Activities Provides Tax Parity Between Taxable Activities of Social Clubs and Taxable Businesses

Interpreting Section 512(a)(3)(A) so as to allow aggregation of tax profits and losses arising from a social club's

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[17] In other circumstances, income and expenses which are nominally from nonmember functions are treated as member income and expenses. For example, income from parties of eight or fewer persons is treated as member income, and directly connected deductions are member expenses, even if seven of the eight are nonmembers. Rev. Proc. 71-17, 1971-1 C.B. 683.

unrelated business activities best accommodates the terms and purposes of Section 512(a)(3)(A). One of the main purposes of Section 512(a)(3)(A) is to ensure that tax exempt social clubs have basically the same tax liabilities on their nonmember business income as taxpaying businesses. *See, e.g.*, S. Rep. No. 94-1318, 94th Cong., 2d Sess. 3 (1976-2 C.B. 597, 599). Thus a social club's service of meals to nonmembers should be taxed the same as a for-profit restaurant or hotel. For-profit businesses are allowed to deduct net losses from one business activity against net income from a different business activity.[18] A plain reading of Section 512(a)(3)(A) should allow an exempt social club to deduct net losses incurred in its food and beverage unrelated business from net income on its investment unrelated business.

This reading of Section 512(a)(3)(A) is supported by the history of the administration of the statute from 1969 to 1981, as embodied in the proposed Treasury Regulations and other administrative materials from that period. Proposed Regulations Section 1.512(a)-3 was issued by the I.R.S. fourteen months after enactment of Section

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[18] For example, the Service does not disallow deduction where a recreational facility operates at a loss on its food and beverage operations, but operates at a profit overall. If that were the case, every gambling casino, bowling alley, dinner theater, movie house, sports stadium, and other recreational facility would have to show continuing net tax profits on its food and beverage activity and each other activity in order to avoid disallowance of expenses. This Court can take judicial notice that recreational facilities typically show tax losses on one activity and tax profits on other activities, and are still allowed to deduct all expenses.

512(a)(3),[19] and remained outstanding until midway through the trial of this case in the Tax Court. These Regulations allowed a social club to aggregate all its unrelated gross income and deductions in one hotchpot, just as taxable businesses do, to determine the club's net unrelated business taxable income. Proposed Regulations § 1.512(a)-3(b)(3). As the Sixth Circuit and the Tax Court agreed[20]; these Regulations support the position that excess unrelated business food/beverage expenses should offset unrelated business investment income. From 1971 to 1987 these Proposed Regulations served as the rules for administration of Section 512(a)(3),[21] and I.R.S. administratively interpreted them to allow tax exempt social clubs to offset losses on food/beverage unrelated business activities against net income from investment unrelated business activities. It was only after the Sixth Circuit decided the issue in *Cleveland Athletic Club* adversely to I.R.S. that it withdrew these Regulations, without notice or comment, on January 26, 1987.

These Proposed Regulations, and their application during the immediate years after the enactment of

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[19] The Tax Reform Act of 1969 was enacted on December 30, 1969. Proposed Regulations § 1.512(a)-3 was issued on May 13, 1971, 36 Fed. Reg. 8809, and was withdrawn on January 26, 1987, 52 Fed. Reg. 2724.

[20] *Cleveland Athletic Club v. United States, supra*, at 1166; *North Ridge Country Club v. United States, supra*, 89 T.C. at 580.

[21] For example, I.R.S.' national training manual for 1980 states that "The proper method of allocating expenses for the purpose of determining tax in cases involving dual use of facilities or personnel is stated in Reg. 1.512(a)-1" – referring to Proposed Reg. § 1.512(a)-1. *Exempt Organizations Annual Technical Review Institutes for 1980*, Training 3177-01 (Rev. 2-80), p. 88.

Section 512(a)(3), constitute a contemporaneous construction of the statute. The Treasury's "substantially contemporaneous expressions of opinion are highly relevant and material evidence of the probable general understanding of the times and of the opinions of men who probably were active in the drafting of the statute. As such, they are entitled to serious consideration * * * ." *White v. Winchester Club*, 315 U.S. 32, 41 (1942); see *Better Business Bureau v. United States*, 326 U.S. 279, 286 (1945). Even contemporaneous private rulings have been accorded great weight.[22] This consistent contemporaneous administrative practice reflected in the Proposed Regulations should be accorded at least comparable weight.[23]

F. The Government's Profit-Equals-Taxable-Income Theory Emasculates the Exempt-Unrelated Business Dichotomy of Section 512(a)(3)

The Government's requirement—that in order to deduct expenses, a social club must have unrelated business gross income in excess of otherwise deductible unrelated business expenses—conflicts with the exempt function – unrelated business dichotomy in the statute, and goes far beyond any rule needed to preclude a club's deduction of personal, hobby or recreational expenses. The Government's proposed rule would treat as nondeductible exempt activity expenses a wide variety of expenses which have little or nothing to do with members' recreation or hobbies. For example, here most of the food-beverage

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[22] *Squire v. Capoeman*, 351 U.S. 1, 9 (1956); *Rowan Companies v. United States*, 452 U.S. 247, 261-262, fn. 17 (1981).

[23] Of course, we recognize that Proposed Regulations in and of themselves have no independent force or effect.

unrelated business activities were nonmember parties which by definition few members attended, and which were paid for by nonmembers. But the Government's formula would treat as nondeductible exempt activity expenses a portion of the expenses for light, heat, staff salaries, and other fixed expenses which are allocable to such nonmember parties. Such expenses are not hobby, recreational or other personal member expenses; they are the ordinary and necessary costs of generating the economic gains which were provided by the unrelated business activities. Indeed, the undisputed evidence here was that the unrelated business was a serious inconvenience to the members. (RT 28-34.)

The Government concedes that all interest and taxes allocated to the nonmember food and beverage functions are deductible because these statutes have no "trade or business" requirement. There is no rational basis in the Section 512(a)(3) terms, or in the intent to preclude hobby loss deductions, for distinguishing rent, heat, light and other fixed expenses and disallowing a deduction of a part thereof.[24]

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[24] The Proposed Regulations issued in 1971 allowed deduction of all – not some – allocated fixed expenses. Section 1.512(a)-3(b)(3) and (5) provide that all gross income and deductions not directly connected to exempt (member) gross income should be aggregated – including allocable portions of all fixed expenses – to arrive at taxable income. Section 1.512(a)-3(c)(iv) provides a sample computation in which the aggregated nonmember expenses are shown as one deduction number; there is no breakdown of nonmember profits or losses by fragmented activities.

Nothing in these Regulations suggests a disallowance of fixed expenses which are directly connected with nonexempt

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The Government is attempting to use this relatively small unrelated business tax case as a vehicle for establishing its novel theory that profit motive requires profit to equal taxable income. If this Court accepts that definition, I.R.S. will be able to deny loss deductions for other tax exempt organizations, and even taxable businesses, solely on the basis of computer runs of their past tax returns. Indeed, I.R.S. District Directors in Western states have done just that to many social clubs. The Government's rigid "taxable income" computational definition, and computer audits based thereon, fundamentally conflict with this Court's teachings that the "resolution of this issue 'requires an examination of the facts of each case.' " *Commissioner v. Groetzinger, supra,* at 988, quoting *Higgins v. Commissioner,* 312 U.S. 212, 217 (1941). What was said of a Government-proposed formula for determining nontaxable gifts applies a fortiori to the business expenses here (*Commissioner v. Duberstein,* 363 U.S. 278, 284, 289 (1960)):

> The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. We reject this invitation. We are of the opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the

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income, on the basis of profit motive or otherwise. Petitioner here exactly followed these Proposed Regulations. The Treasury Department has never issued any other Regulations which would require nondeductibility of fixed expenses directly connected with nonexempt income. The courts are not the place to legislate such a nondeductibility rule.

> problem is one which, under the present statutory framework, does not lend itself to any more definitive statement.

II

ALTERNATIVELY, IF THIS COURT INCORPORATES A PROFIT MOTIVE REQUIREMENT, IT SHOULD ADOPT THE TAX COURT'S ECONOMIC PROFIT TEST.

A. The Tax Court's Standard Properly Considers All Facts, Including Economic Profits

The Tax Court in its unanimous reviewed opinion in *North Ridge Country Club v. Commissioner,* 89 T.C. 563 (1987), as in the instant case, did not decide whether Section 162 was incorporated into Section 512(a)(3). Instead, it found that, even if it assumed Section 162 was so incorporated, then the two taxpayers earned a profit using the normal "economic profit" tests which courts have applied in business deduction cases under Sections 162, 165, and 167.

Under this standard profit motive standard, a taxpayer must have an actual and honest objective of making a profit. *Dreicer v. Commissioner,* 78 T.C. 642, 644-645 (1982); *Golanty v. Commissioner,* 72 T.C. 411, 425-426 (1979), *aff'd* without published opinion, 647 F.2d 170 (9th Cir. 1981). A taxpayer's expectation of making a profit need not be reasonable; it is sufficient that the taxpayer have a bona fide objective of making a profit. *Beck v. Commissioner,* 85 T.C. 557, 569 (1985); *Fox v. Commissioner,* 80 T.C. 972, 1006 (1983), *aff'd* without opinion, 742 F.2d 1441 (2d Cir. 1984); *Dreicer v. Commissioner,* 665 F.2d 1292, 1297 (D.C. Cir. 1981). In determining the intent of a taxpayer, all relevant facts and circumstances must be

taken into account. *Commissioner v. Groetzinger, supra; Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965).[25]

The Tax Court in the instant case and in *North Ridge* applied its usual facts and circumstances test for determining profit motives under the trade or business term in Sections 162, 165 and 167. It listed the following factors indicating profit motive, all of which are typical of those employed by courts over the years in making such determinations (as noted in the footnotes):

1. Petitioner's activities were run in a business-like manner. (J.A. 30.)[26]

2. It kept complete and accurate books and records of its activities. (J.A. 30.)[27]

3. Its operations were overseen by a board of directors of nine members which met at least monthly, and supervised and reviewed the actions of the general manager and other staff. (J.A. 30.)

4. Its board was made up of business people and professionals from various backgrounds, who met regularly, and discussed and dealt with the financial and other problems relating to nonmember food and beverage sales and financial operations. (J.A. 30)[28]

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[25] An exhaustive list of all possible factors under Section 162, and illustrative cases, is set forth in J. Lee, *A Blend of Old Wines in New Wineskins*, 29 Tax. L. Rev. 347, 395-464 (1974).

[26] *Bessenyey v. Commissioner*, 45 T.C. 261, 275 (1965), *aff'd*, 379 F.2d 252 (2d Cir. 1967), *cert. den.*, 389 U.S. 931 (1967); *Eastman v. United States*, 635 F.2d 833, 840 (Ct. Cl. 1980).

[27] E.g., *Whitney v. Commissioner*, 73 F.2d 589, 591 (3d Cir. 1934).

[28] E.g., *Roonen v. Commissioner*, 90 T.C. 74, 93-94 (1988).

5. It had a standing finance committee which met monthly to review financial statements, conduct studies concerning the financial aspect of petitioner's operations, and generally to discuss the implementing of board policy. (J.A. 30.)[29]

6. The finance committee regularly analyzed dining room finances, determined that private party (nonmember-unrelated) functions generated higher than average sales and resulted in a financial profit, and instituted programs to increase nonmember business. (J.A. 30-31.)[30]

7. Petitioner employed a full time, professional manager, who had a bachelor of science degree in hotel and restaurant administration and a bachelor of science degree in recreation administration; had previous employment experience with hotels and private clubs; and was a certified club manager who served as an officer of the local and state club and restaurant associations. (J.A. 30-31.)[31]

8. It encouraged nonmember food and beverage business with the intent to attract additional members to the club. The addition of new members resulted in increased income from each $7,000 initiation fee. Increased business also contributed to the sharpening of the skills of the chef and his staff. (J.A. 31.)[32]

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[29] E.g., *Babbitt v. Commissioner*, 23 T.C. 850, 867-868 (1955); *Churchman v. Commissioner*, 68 T.C. 696, 702 (1977).

[30] *Id.*

[31] E.g., *Appley v. Commissioner*, 39 T.C.M. 386 (1979); *Patterson v. United States*, 459 F.2d 487 (Ct. Cl. 1972); *Roonen v. Commissioner, supra*, at 95.

[32] See *Burleson v. Commissioner*, 46 T.C.M. 1394 (1983). The new members and additional business likely increased the value of Petitioner's facility, which indicates a profit motive. See pp. 40-41, *infra*.

The Government has not disputed that all of these factual findings are correct, or contended that they are not the usual and proper factors for determining whether a profit motive and a trade or business exist. However, the Government contends that the Tax Court legally erred in considering and giving weight to two other factors respecting profit motive – the Tax Court's findings (i) that Petitioner priced food and beverages served at nonmember activities at an amount intended to result in a profit to the club over the direct costs associated with the activity, and (ii) that Petitioner also earned a profit from nonmember sales when it deducted the variable costs, plus fixed expenses on a use of space allocation.

The Government contends that these findings are legally erroneous because they are assertedly premised on an erroneous definition of the term "profit" for purposes of determining profit motive. It insists that "profit" means an excess of gross income over deductible direct (variable) plus indirect (fixed) expenses, computed according to the allocation method used on the tax returns.

The Ninth Circuit rejected the tests of the Tax Court and the Government, and held that profit means an excess of gross income over variable plus fixed expenses, and expenses for this purpose may be computed using any reasonable allocation method (not necessarily that used for computing deductions on the tax return). (J.A. 44-45.)[33]

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[33] The Second Circuit in *The Brook, Inc. v. United States*, 799 F.2d 833 (2d Cir. 1986), held that Section 162 was incorporated into Section 512(a)(3)(A), but did not address the issue as to the definition of "profit" for profit motive purposes. This was because the taxpayer there broadly stipulated that it had no profit motive when it engaged in the unrelated activity of selling meals to nonmembers. *Id.*, 799 F.2d at 838.

We submit that, assuming Section 162 is incorporated into Section 512(a)(3)(A), the Tax Court's definition of profit motive is correct. That definition uses the same basic economic profit standards which it and other courts have applied in numerous cases which have determined profit motive for trade or business purposes in Sections 162, 165, and 167.

The cases have uniformly held that taxable businesses, in order to deduct expenses in excess of income, need only show an "economic profit" independent of tax savings[34], or "economic gain" independent of tax savings.[35] The Treasury Regulations which define profit motive for purposes of Section 512(a)(1) state that the term means "economic profit (without regard to tax consequences)."[36] While the "economic profits" and "economic gain" terms have been given slightly different meanings depending on the peculiar circumstances, the most common meaning is cash flow, or an excess of cash income over cash expenses.[37]

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[34] *Simon v. Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987); *Surloff v. Commissioner*, 81 T.C. 210, 233-235 (1983) (economic profit is cash profit on each ton of coal in coal mining partnership); *Seaman v. Commissioner*, 84 T.C. 564, 588 (1985); *Rice's Toyota World, Inc. v. Commissioner* 81 T.C. 184, 202-210 (1983); *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984); see also *Landreth v. Commissioner*, 859 F.2d 643, 649 (9th Cir. 1988).

[35] *Hilton v. Commissioner*, 74 T.C. 305, 355-361 (1980) (economic gain in shopping center sale-leaseback can be pre-tax net income or loss plus net proceeds from mortgage financing, condemnation or sale, or cash flow; R. Waters, *Sideline Ventures; Planning to Achieve Maximum Tax Benefits from Losses Incurred*, 29 J. Tax 100 (1968).

[36] Treas. Regs. § 1.512(a)-1(f)(7)(ii).

[37] See, *e.g.*, S. Rep. No. 91-552, 91st Cong., 1st Sess. 212 (1969) (1969-3 C.B. 423, 557); H. Rep. No. 91-413, Pt. 1, 91st

(Continued on following page)

"Economic profit" is thus usually quite different from taxable income, for the latter includes all deductible expenses, not just out-of-pocket outlays.[38] In computing "economic profit," courts frequently allow the taxpayer to include not only current income, but also reasonably anticipated capital appreciation on the sale of the asset or business in question.[39] Section 183, which does not apply to corporations, but which incorporates tests for profit motive based on the cases, implicitly incorporates an "economic profit" test, for it recognizes that reasonably anticipated long-term increases in the value of the

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(Continued from previous page)

Cong., 1st Sess. 165 (1969) (1969-3 C.B. 303); H. Rep. No. 94-658, 94th Cong., 2d Sess. 31 (1976-3 C.B. (Vol. 2) 703, 723); *Waddell v. Commissioner*, 86 T.C. 848, 884 (Table 10), 887, 894 (1986); *Gefen v. Commissioner*, 87 T.C. 1471, 1490-1492 (1986) (profit equals cash flow plus residual value of property in sale-leaseback transaction); *Wildman v. Commissioner*, 78 T.C. 943, 954 (1982) (profit is cash return on cash investment, not taking into account potential payments due on nonrecourse note or non-cash deductions); J. Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 Tax Law Rev. 347, 380-385 (1974); R. Waters, *supra*, note 35.

[38] *Hartford v. United States*, 265 F.Supp 86, 88 (W.D. Wis. 1967) (profit means excess of gross income over cash expenses, not gross income over deducted expenses); cf. Treas. Regs. § 1.704-1(b)(3)(ii)(*b*) and 1.512(a)-1(f)(7)(ii); *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1062 (1986).

[39] E.g., *George v. Commissioner*, 22 B.T.A. 189, 195 (1931) (cash profits plus appreciation in value of land held to constitute requisite profit); *Wroblewski v. Commissioner*, 32 T.C.M. 169, 172 (1973) (the same); *DuPont v. United States*, 234 F. Supp. 681, 688 (D. Del. 1964); J. Lee, *supra*, note 37.

property[40] constitute a factor in the profit motive determination.[41]

In *Estate of Baron v. Commissioner*, 83 T.C. 542, 556 (1984), the Government argued that "economic profit" was the correct standard for determining profit motive, while the taxpayer contended that tax savings should also be considered. The Court held that economic profit existed if there were cash profits, and they were not disproportionately lower than the tax savings.[42] In the instant case, Petitioner plainly satisfies this standard, because in the years in issue, it had cash profits of $50,741, but its tax savings were only $5,298.[43] (J.A. 29, 50.)

The tax shelter cases, where the issue of a Section 162 profit motive frequently arises, make no sense if one assumes that profit means taxable income. In most of the cases, it was conceded that the tax shelter would show continuous losses after deduction of noncash expenses; the issue was whether the shelter intended to earn an economic profit. If the Government's definition of profit is correct, most of the discussion of profit motive in these

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[40] Treas. Regs. § 1.183-2(b)(4); see Comment, *Analysis of New Code Section 183 and Some Ramifications for the Resort Home*, 9 Willamette L.J. 117, 122 (1973); J. Lee, *supra*, note 37, at 385-386.

[41] E.g., *Sanderson v. Commissioner*, 23 T.C.M. 1723, 1729 (1964).

[42] Accord, *Waddell v. Commissioner*, 86 *supra*, 894.

[43] A.C. Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985, 991-992 (1981), disagrees that any comparison of tax benefits and cash flow should be made, and take the position that profit means a "barely positive return", *i.e.*, a small cash flow. Accord, I.H. Humphreys, *Establishing Profit Motive in Tax Shelters*, 3 J. Tax. of Investments 250, 259 (1986).

cases is useless verbiage. The cases should have been decided for the Government when the shelter entity disclosed its intent to generate continuing *tax* losses.

Thus, an office building partnership can deduct expenses in excess of income – created by permissible deductions for depreciation, interest, taxes, etc. – if it can demonstrate that it has a reasonable intent to earn economic profits, defined as gross income less the out-of-pocket expenses, but not taking into account the tax benefit of the write-offs – even if (as is usual) the entity shows continuing losses on its tax returns.

The I.R.S. itself, in its Tax Shelter Manual and in various rulings, has stated that profit motive requires an economic profit.[44] Indeed, in the only published ruling addressing the issue in the social club context, I.R.S. has stated that profit means gross income in excess of allocable *variable* costs. In Rev. Rul. 81-69, 1981-1 C.B. 351, it was held that a club did not have a profit motive when "it sold the food and beverages [to nonmembers] *at prices insufficient to recover the cost of sales* * * *[45] Despite the clear wording of this Ruling, however, I.R.S. has administratively determined that Petitioner and other clubs did not have a profit motive even where gross income *exceeded costs of sales*, but was less than the sum of deductible fixed costs plus deductible costs of sales.

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[44] I.R.S. Examination Tax Shelters Manual, par. 444(3)(c) (May, 1989); *cf.* Rev. Proc. 75-21, 1975-1 C.B. 715, 716.

[45] Webster's *Third New International Dictionary* (unabridged) defines "cost of sales" to mean "1. * * * the purchase cost or inventory value of merchandise sold during a stated period plus the cost of direct work thereon * * * ; 2. * * * the production costs or inventory value of goods sold during a stated period. * * * ."

B. The Government's Taxable Income Test is Inconsistent with the Profit Motive Test Applied to Taxable Corporations

The Government's position in this case, that a profit motive cannot exist where a taxpayer has consistent *tax* losses, is simplistic and ignores the realities of federal income taxes in modern times. If that position were correct, Congress' enactment, and repeated refining and tightening of the minimum tax and the alternative minimum tax, would not have been necessary. These taxes are required because of "existing tax preferences . . . which generally cause a taxpayer's taxable income to be less than economic income . . . ." U.S. Treasury Dept., *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 2, at 114 (Nov. 1984). Indeed, in the Tax Reform Act of 1986, Congress recognized that corporations can generate significant economic profits but nonetheless report continuing tax losses, and specifically provided that corporations must use book income, rather than taxable income, for purposes of computing the alternative minimum tax. *See*, Section 56(f) of the Internal Revenue Code of 1986.[46] Obviously, these minimum tax provisions would not be necessary if the Government could merely hold that a corporate taxpayer had no profit motive on any activity where tax deductions consistently exceeded gross income (*e.g.*, oil and gas drilling and exploration activities), and disallowed deductions for expenses in excess of gross income. The Government has never, however, claimed

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[46] The Tax Reform Act of 1986 has a whole set of provisions designed to deal with problems which are titled "Business untaxed reported profits." In pre-1986 years, the reported profits were "untaxed" because the corporations had *deductible* costs in excess of gross income.

such authority with regard to taxable corporations, and has instead attempted to limit the tax advantages of tax deductions in excess of gross income through the minimum tax and the alternative minimum tax.[47]

Code Section 56(f) adds to the tax preference items of a corporation a percentage of the untaxed reported profits of that corporation. If "profits" were "taxable income" as maintained by the Government, this statute would never add a penny to a corporation's preference items for minimum tax purposes, because they would always be taxed as "taxable income" under Code Section 11. If the I.R.S had confidence in the argument made in this case, that a series of years in which a corporation had no taxable income and paid no taxes proves it had no profit motive, Code Section 56(f) would have been unnecessary.

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[47] A former Treasury Department tax advisor described the problem as follows (M. Hevener, *Minimum Tax and Alternative Minimum Tax, Computation and Application*, 288-3d Tax Management A-70 (1987)):

> Theoretically, there should be little disparity between income for financial accounting purposes and income for tax purposes as long as the income tax base is reasonably comprehensive and deductions are limited to those required to accurately measure net income. In recent years, however, the regular federal income tax system has fallen far short of satisfying these two conditions, and the supplementary minimum tax system has not come that much closer. The Tax Reform Act of 1986 represents probably Congress' most determined effort ever to bring the federal income tax base closer to economic income. In particular, the revised minimum tax rules, eliminating for minimum tax purposes the incentive effect of the bulk of preferences still allowed for regular tax purposes.

Congress determined Code Section 56(f) necessary because many very profitable corporations were consistently deducting expenses in excess of gross income, and thus never paying income taxes.[48]

If this Court were to accept the Government's definition of profit, it would reasonably conclude that none of the corporations listed in the margin was engaged in activities with an intent to make a profit. These corporations, just as Petitioner, used the available choices in the Code to reduce their taxes to zero. These corporations, just as Petitioner, intended to make an economic profit. These corporations, as well as the Petitioner, actually did make an economic profit. They merely chose to use the flexibility built into the code to reduce their taxes legally, by not reporting a tax profit.

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[48] From 1981 through 1984, the following corporations paid no federal income tax, but reported profits each year to the SEC and their shareholders as noted below (Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* (July 1986)):

Corporations	1981-84 Reported Profits
Boeing Company	$2,099,000,000
Lockheed Corporation	$1,670,900,000
Grumman Corporation	$ 653,400,000
Greyhound Corporation	$ 419,900,000

From 1982 through 1985, the following corporations paid no federal tax, but reported profits each year to the SEC and their shareholders as listed below (*id*):

Corporations	1982-85 Reported Profits
Middle South Utilities	$2,477,800,000
General Dynamics	$1,994,500,000
Panhandle Eastern Corporation	$1,063,500,000
Union Can Corporation	$ 690,900,000
Transamerica Corporation	$ 525,000,000
Mitchell Energy and Development	$ 362,900,000
Coamerica	$ 169,300,000

If "profit" and "taxable income" were the same, the question whether a taxpayer has a profit motive could depend on whether it elected an accrual or a cash method of accounting, whether it elected to amortize or capitalize certain expenses, whether it elected accelerated or straight line depreciation, or even in which year it would choose to purchase a capital asset. These decisions do not increase or decrease the gross economic income of the taxpayer, nor do they increase or decrease the actual expenses paid; they merely regulate the tax treatment of the income and expenses.

C. The Government's Taxable Income Test Is Inconsistent with Basic Accounting Definitions of Profit

The concept of earning economic gain or profit, in the sense of revenues exceeding direct (variable) expenses, is well accepted in the accounting field. It is based on the common sense notion that if certain overhead costs are relatively fixed, any extra business which generates revenues in excess of variable costs increases the amount of funds available to the business. This is why restaurants can afford to offer discount meals at off-peak times, and still make a profit on them.

In accounting, economic profit is determined under a "relevant cost approach"[49], which is shown on a "contribution form of economic statement."[50] This is quite different from the "function form of income statement," which spreads all fixed and variable costs equally over all sales,

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[49] C.T. Horngren, *Introduction to Management Accounting*, (4th ed. 1978), 81.

[50] Horngren, *supra*, at 65-66, 86-87.

and results in a type of profit similar to that contended by the Government.[51]

Using the contribution form of economic statement in Professor Horngren's text, Petitioner had roughly $22,601 and $28,140 greater net income with its nonmember business than without it in 1980 and 1981 respectively.[52] By generating a total of $190,000 in unrelated business sales in 1980-1981, Petitioner produced a total of $50,000 in funds which it otherwise would not have had.[53] Dropping nonmember business would cause a decrease in the Petitioner's overall economic net income of about $50,000 for the two years in issue.[54] Such extra income produced by nonmember business is surely "profit" under any realistic definition of a "profit motive."

D. The Ninth Circuit's Profit Motive Formula Is Totally Unprecedented and Untested

The Ninth Circuit's opinion cites no authority for its position that profit means an excess of gross income over the sum of variable costs, plus fixed costs computed under any proper allocation method. That definition is contrary to the "economic profit" standard which has been consistently applied by the decisions, and approved by the commentators discussed in Part II, A, above. The

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[51] *Id.* at 87.

[52] See Tables 1 and 2, Appendix C, *infra*, which follow the format in the Horngren accounting text, *supra*, at 87, Ex. 4-3. These tables were included in Petitioner's Tax Court brief.

[53] *Id.*, Tables 1, 2.

[54] *Id.*

Ninth Circuit's text is also in conflict with the accounting notion of economic profit. (See Part II, C, above.) These authorities hold that economic profit is gross income in excess of variable expenses.

While the Ninth Circuit's formula is better than that of the Government, it is basically unprincipled and conflicts with the reality of economic profits. If this Court were to adopt this test, we believe that the Tax Court's opinion should be affirmed. No remand would be necessary, since the Tax Court already found that Petitioner had a profit, and a profit motive, when profit means gross income in excess of variable and fixed costs, using the actual use method of allocating for fixed costs. (J.A. 28-29.)

CONCLUSION

For the reasons stated, the judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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APPENDIX A

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

Sec. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) Charitable, Etc., Organizations Taxable at Corporation Rates. –
  (1) Imposition of tax. – There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income."
  (2) Organizations subject to tax. –
    (A) Organizations described in sections 401(a) and 501(c). – The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

Sec. 512. UNRELATED BUSINESS TAXABLE INCOME

(a) Definition. – For purposes of this title –
  (1) General rule. – Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated

trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

* * *

(3) Special rules applicable to organizations described in section 501(c)(7) or (9). –

(A) General rule. – In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income (including exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

(B) Exempt function income. – For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from

any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside –

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

APPENDIX B

NET INCOME OF PORTLAND GOLF CLUB COMPUTED PER "SQUARE FOOT AND HOURS OF ACTUAL USE" ALLOCATION METHOD

	11 Months Ending 9/30/80			Year ending 9/30/81		
	Dining Room	Bar	Total	Dining Room	Bar	Total
Sales	$68,122	$16,300	$84,422	$85,134	$21,413	$106,547
Variable expenses:						
Food & Liquor	27,249	5,183	32,432	34,054	6,617	40,671
Labor & Other Related Costs	14,540	5,281	19,821	16,868	7,259	24,127
Other	8,362	1,206	9,568	11,853	1,756	13,609
	$50,151	$11,670	$61,821	$62,775	$15,632	$78,407
Excess of Sales over Variable Expenses	$17,971	$ 4,630	$22,601	$22,359	$ 5,781	$28,140
Fixed Expenses	3,153	0 *	3,153	4,666	0 *	4,666
Profit	$14,818	$ 4,630	$19,448	$17,693	$ 5,781	$23,474

*Fixed expenses are included under Dining Room.

Source: J.A. 29.

APPENDIX C

TABLE 1
Comparison of Operating Income of Taxpayer
With and Without Noninvestment Unrelated Business
Income Eleven Months ending September 30, 1980*

Revenues	Without Unrelated Business	With Unrelated Business			Difference With Nonmember Unrelated Business
		Related	Unrelated	Total	
Dues and Initiation Fees	$ 781,422	$ 781,422	$ –	$ 781,422	
Total Related Sales from Food, Beverage & Other Service Programs	765,448	765,448	84,422	849,870	$84,422
Total Revenues	$1,546,870	$1,546,870	$84,422	$1,631,292	$84,422
Less Related Variable Expenditures	1,273,749	1,273,749	61,821	1,335,570	61,821
Contribution Margin	$ 273,121	$ 273,121	$22,601	$ 295,722	$22,601
Less Total Fixed Expenses	156,749	–	–	156,749	0
Operating Income	$ 116,372	–	–	$ 138,973	$22,601

* Figures were obtained from Form 990, the audited financial statement of Petitioner for years ending September 30, 1980 and September 30, 1981, adjusted to reflect 11 months taxable year for 1980 (J.A. 52-72) and from Exhibits 15-O (J.A. 85), 16-P and 17-Q.

TABLE 2
Comparison of Operating Income of Taxpayer With and Without Noninvestment Unrelated Business Income Fiscal Year ending September 30, 1981*

Revenues	Without Unrelated Business	With Unrelated Business			Difference With Nonmember Unrelated Business
		Related	Unrelated	Total	
Dues and Initiation Fees	$ 840,929	$ 840,929	$ –	$ 840,929	
Total Related Sales from Food, Beverage & Other Service Programs	871,619	871,619	106,547	978,166	$106,547
Total Revenues	$1,712,548	$1,712,548	$106,547	$1,819,095	$106,547
Less Related Variable Expenditures	1,512,185	1,512,185	78,407	1,590,592	78,407
Contribution Margin	$ 200,363	$ 200,363	$ 28,140	$ 228,503	$28,140
Less Total Fixed Expenses	159,491	–	–	159,491	0
Operating Income	$ 40,872	–	–	$ 69,012	$28,140

* Figures were obtained from Form 990, the audited financial statement of Petitioner for years ending September 30, 1980 and September 30, 1981, adjusted to reflect 11 months taxable year for 1980 (J.A. 52-72) and from Exhibits 15-O (J.A. 85), 16-P and 17-Q.